CREDIT MARKETS

Detroit is Bankrupt

Four months after filing for bankruptcy protection, the Federal Bankruptcy Court Judge Steven Rhodes ruled that the city of Detroit is eligible for Chapter 9 after a nine-day eligibility trial. The city claims that it cannot continue to provide basic services and repay its estimated $18 billion in liabilities. Detroit is officially the largest municipality in the U.S. to qualify for Chapter 9 protection. While the judge ruled in favor of the city, he also made a point to emphasize the city did not negotiate in good faith with its 100,000 creditors by not allowing enough time for interested parties to respond to its restructuring proposal to creditors. However, due to the insolvent nature of the city and the impracticality of negotiations with such a large number of creditors, he ruled that the city should be allowed to move forward with bankruptcy proceedings. Additionally, the ruling allows pension benefits to be impaired as part of the restructuring process. The city will now begin new negotiations with creditors to produce a "plan of adjustment" before a March 1st deadline.

It is widely expected that there will be multiple challenges to the legality of altering pension benefits from the labor unions. Under the state of Michigan's constitution, pension benefits are protected as a contractual right. However, Judge Rhodes clearly stated that the state's protections do not apply to the federal bankruptcy court. This ruling is a watershed event in the municipal market as it has always been widely held that unlimited tax general obligation and essential service revenue bond holders would be paid in full, even from highly stressed issuers. However, Detroit's bankruptcy plan has classified these debts the same as pension obligations and other unsecured liabilities. The municipal market will look to this case as important precedents could be set for how municipal creditors and pensioners are paid in cases of insolvency.

Illinois Passes Pension Reform, but leaves Chicago out

On December 3rd, the state of Illinois took a major first step to reforming the state's grossly underfunded pension system. Currently, the state's pension system is approximately only 40% funded, making it one of the lowest funded systems in the US. This extremely low funding ratio is a major contributing factor to the state's credit rating. The state currently has the lowest credit rating of any state and is rated A3 by Moody's and A- by S&P with both agencies maintaining negative outlooks. The pension reform bill plans to fully fund the pension liability by 2044, yet it passed by narrow margins after months of contentious political debates. The reforms center largely on modifying annual cost of living (COLA) adjustment benefits, enabling the fund to sue the state to make annual required contributions, raising the retirement age for workers younger than 46 and the pledge of supplemental contributions to be annually made by the state. Additionally, the bill creates a defined-contribution plan that will be available to employees to move to voluntarily if they choose.

The bill has passed the legislature and is expected to be signed into law by Governor Pat Quinn; however, the Supreme Court of Illinois will likely determine final changes. The labor unions have already announced that they plan to challenge the bill in the state court system. They maintain that pension benefits are a contractual right that cannot be "diminished or impaired" as guaranteed by the Illinois Constitution. It will likely take months for the legislation to be ruled on by the higher court.

Notably missing from the state's pension reform bill was legislation addressing the city of Chicago's pension system. Mayor Rahm Emanuel had attempted to link the city's pension system much needed reforms to the state's bill. If no reforms are passed, the city of Chicago will see its annual required contribution almost triple from $590 million to $1.4 billion in fiscal year 2015. According to Fitch Ratings the city would have to increase property taxes 35% to meet the increased ARC. Again, any significant pension reforms would likely be challenged in the state court system.

The State of our Infrastructure

On November 15th, the New York Society of Security Analysts (NYSSA) held a conference on the state of the infrastructure in the U.S. and beyond. The conference focused on transportation, energy & utilities, telecom and essential services. Most of the U.S. infrastructure was built in the 1960s and there has been insufficient investment to maintain and or build updated systems. The American Society of Engineers assigned the infrastructure a D+ on its grading scale and estimates a projected $3.6 billion in projected capital needs. Roads are going to require the most spending at an estimated $1.7 billion in capital needs. Municipal bond issuance was historically the primary way such large capital projects were funded and maintained. As our systems become more outdated, more projects have sought out private sector funding; however, we believe municipal bonds will continue to be an important financing vehicle for such large scale investments.

More Credit Positives

The **Commonwealth of Pennsylvania** positively passed a transportation-funding bill, which is a credit positive not only for the Pennsylvania State Turnpike Commission (PTC) rated A1/Stable, but for the Commonwealth rated Aa2/Stable as well. The new law provides a recurring revenue stream by increasing various fees such as oil company franchise tax, vehicle registration, driver's license, and county vehicle registration. The Commonwealth has not had a sound transportation funding policy since the enactment of Act 44 seven years ago, which created a long-term $450 million annual payment obligation between the PTC and Pennsylvania Department of Transportation (PennDOT). The new law phases this payment out in eight years and provides new bonding capacity for PennDOT.

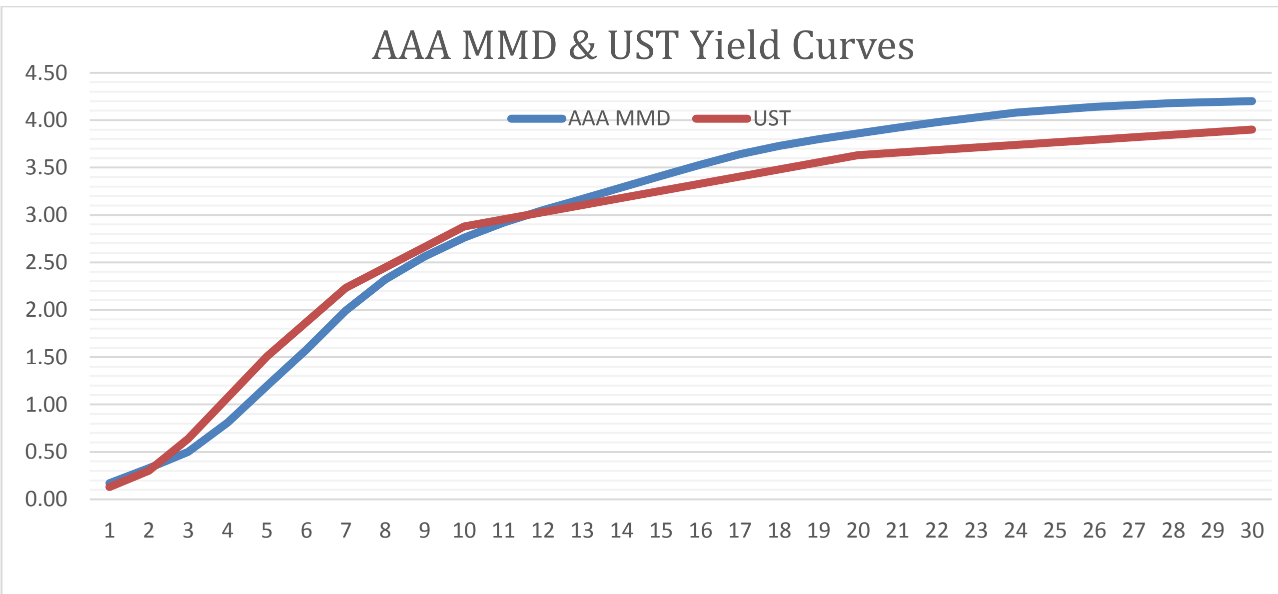
Municipal issuers are defaulting at the slowest pace in four years, according to the Bond Buyer, despite large credits such as Puerto Rico and Detroit making negative headlines. Thus far in 2013 only 45 issuers have defaulted, which is less than half the number from a year earlier. As cities and states emerge from the longest recession in U.S. history since the 1930s, local finances are strengthening and state tax revenues have grown for 15 straight quarters. Additionally, previous headline makers have been able to return to the debt markets and issue new debt. Jefferson County, Alabama, previously the largest municipal bankruptcy prior to Detroit, returned to the market in November and successfully issued a $1.7 billion deal.

TRADING MARKETS

November has historically been a favorable month for the municipal market, but with a continued rally in the equity market and a steady flow of positive economic numbers, municipal rates followed treasuries, ending higher for the month. Combined with the added lack of direction from the primary issuance market (with 31% less issuance than a year ago), it was the second worst November for overall performance since 2004. As retail investors chase the record highs in stocks, outflows from the municipal market added more selling pressure to mutual funds. As of the week ended December 4th, the muni market had seen 28 consecutive weeks of redemptions putting the municipal market on track for its first negative annual return for intermediate maturities of municipal bonds since 1999.

Activity slowed as November wore on with each delayed release of economic data and speculation that a December taper was a possibility. Since bond prices moved down so abruptly over taper talks this summer, many traders believe the pull back of the QE3 bond buying program has been priced into the fixed income market. Rates continue to hold the yield curve close to historical steepness and general market consensus believes they will continue to rise. Maturities inside five years had the strongest demand and forced selling sent yields higher, while the slope of the curve was in need of buyers between 10 and 30 years. There was, however, an outperformance of the 30-year part of the curve as AAA MMD yields rose 6 basis points while the 10-year AAA MMD saw a 21 basis point rise. This can be attributed not only to the higher volume of selling in the intermediate part of the curve, but also to retail investors locking in AA credits on par-type bonds in 30 years. The 30-year muni to treasury ratio moved tighter for the third straight month, but closed the month at roughly 107% for AAA MMD yield to UST.

Looking ahead to December, a month which is usually driven by investors figuring their tax-consequences for the year, there are often large swings in either direction on price performance. Issuance during the second half of the month is expected to be muted due to the holidays, and thus a sizable calendar is already forming in the first half of the month. This issuance combined with an uneasiness regarding future Fed plans may continue to put some upward pressure on rates. Most managers and dealers will gain a better understanding of their appetite for munis heading into the New Year and if the outflows continue to slow, month over month, we believe the possibility of a firm feel to start January is likely.



Source: MMD

Looking Ahead to 2014 - Sectors and Stories That Will Make Headlines

Credit: The Detroit bankruptcy saga will drag on for most of 2014. Pensioners will challenge proposed reforms and bondholders will protest haircuts on the general obligation debt. Additionally, the Illinois pension legislation will be challenged in court while Chicago will continue to lobby the state legislature for its own pension reform. Puerto Rico will likely continue to make headlines as the Commonwealth teeters one notch above a junk rating. The Electric Authority of Puerto Rico (PREPA) could likely be the next big Puerto Rico credit to make headlines and possibly rattle the trading market. However, overall, we believe municipal credits will continue to recover from recessionary pressures and we will likely see the amount of credit downgrades decrease in 2014.

Healthcare: As a result of Affordable Care Act (ACA), some hospitals may face additional financial and operational pressures in the near term. However, we believe that hospitals operating in states that have expanded Medicaid eligibility (currently 26) as well as the those operating in states which have started their own health insurance exchanges (HIE's) will generally fair better under ACA. The implementation of the ACA in 2014 could have an impact on hospital financial operations and/or perhaps even hospital yield spreads.

Pensions: Rebounding stock prices will likely benefit many pension funds. We may see funding levels stabilize and or improve slightly as investment returns improve total assets under management. There will also likely be more talks of reforms both to pension benefits and how assets under managements and potential liabilities are valued.

Rates: Rates will likely be mostly range bound with the 10 year treasury yielding 2.75-3.25% throughout most of 2014. We believe rates will be driven by continued modest economic growth and improvement in unemployment data.

Happy Holidays from all of us at Asset Preservations Advisors.
We look forward to working with you in the New Year!

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